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ABSTRACT

The loan collection practices and procedures of guaranty agencies and ways to reduce default costs were assessed by the U.S. General Accounting Office at the request of Congress. Questionnaires were completed by 58 guaranty agencies and visits were made to eight agencies. Before revised regulations were issued by the U.S. Department of Education in November 1986, each guaranty agency was allowed to establish its own collection practices, and the agencies' collection practices varied. The revised regulations required all agencies to pursue five specific actions to collect defaulted loans. These steps, pertaining to the type and frequency of collection attempts, should help to reduce federal default costs. Legislative actions taken in 1986 include a requirement for defaulters to pay reasonable collection costs and reporting to credit bureaus about the borrowers' loans and repayment patterns. Additional suggestions concerning loan collection are presented. Appendices include: examples of major legislative changes to the Guaranteed Student Loan Program and comments from the Department of Education, the Internal Revenue Service, and the National Council of Higher Education Loan Programs, Inc. (SW)

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United States General Accounting Office

GAO

Report to Congressional Requesters

September 1987

GUARANTEED STUDENT LOANS

Legislative and Regulatory Changes Needed to Reduce Default Costs

ED 288436

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GAO

United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-204708

September 30, 1987

The Honorable Pat Williams
Chairman, Subcommittee on
Postsecondary Education
Committee on Education
and Labor
House of Representatives

The Honorable William D. Ford
House of Representatives

This report, issued at the Subcommittee's request, discusses legislative and regulatory changes needed to reduce default costs in the Guaranteed Student Loan Program. The report contains several recommendations to the Secretary of Education and the Congress.

We are sending copies of the report to the appropriate congressional committees, the Secretary of Education, the Commissioner of the Internal Revenue Service, and other interested parties.

Richard L. Fogel
Assistant Comptroller General

Executive Summary

Purpose

Since 1965, the Guaranteed Student Loan Program has provided over $60 billion in loans to students seeking a postsecondary education. Of these loans, students have defaulted on more than $4 billion, $1.3 billion of which occurred in fiscal year 1986. Because the costs of these defaults are generally borne by the Department of Education, Congressman William D. Ford, as Chairman of the Subcommittee on Postsecondary Education, House Committee on Education and Labor, requested GAO to examine what guaranty agencies—which administer the program at the state level—are doing to protect the federal government's interest in collecting defaulted student loans. In particular, GAO was asked to describe (1) the loan collection practices and procedures of guaranty agencies, and (2) ways to reduce default costs. In subsequent discussions with the Subcommittee, GAO also agreed to examine the time defaulters are given to repay loans and whether agencies are promptly remitting the Department's share of collections.

Background

In fiscal year 1986, over 3 million students obtained program loans from about 13,000 lenders. These loans are insured by 58 state and private nonprofit guaranty agencies who are reinsured by the Education Department. When a student fails to repay, the guaranty agency repays the lender and the Department reimburses the agency. The agency then attempts to collect from the student and if successful, retains a portion to defray its collection costs, submitting the remainder to the Department. The Department received about $200 million in such remittances during fiscal year 1986.

GAO sent questionnaires to all 58 guaranty agencies to obtain information on collection practices and visited 8 agencies to obtain additional information.

Results in Brief

Until late 1986, when the Department revised its regulations, guaranty agencies had considerable discretion in how they collected defaulted student loans, and loan collection practices varied. The new regulations standardized and made more stringent these procedures. If properly implemented, they should help reduce federal default costs. Additional legislative and regulatory changes would further reduce student loan default costs and increase federal revenue. For example, guaranty agencies should share all default payments with the Department and remit collections quicker to the Department. Other changes—some of which could help to deter borrowers from defaulting —include (1) increasing

defaulters' interest rates, (2) using a national information system to verify student loan eligibility, and (3) continuing to use federal income tax refunds to offset student loan debts.

Principal Findings

Collection Procedures Standardized

The Department of Education had allowed each guaranty agency to establish its own collection practices and procedures, and the agencies' collection practices varied. But in November 1986, the Department issued new regulations that require all agencies to pursue five specific actions to collect defaulted loans. These steps, pertaining to the type and frequency of collection attempts, should help to reduce federal default costs.

Legislative Improvements

A number of legislative actions taken in 1986 should reduce defaults and increase collections from those who do default. For example, borrowers' loans and repayment patterns will be reported to credit bureaus, and defaulters will be required to pay reasonable collection costs.

Further Improvements Needed

Additional changes are needed to further reduce the federal government's costs. For example, defaulters who begin or resume repayment maintain the same interest rate they received on their original federally subsidized loans (interest is paid by the government). In contrast, borrowers obtaining unsubsidized loans as of July 1, 1987, who default will pay interest that varies with market rates, up to a ceiling of 12 percent. Converting defaulted subsidized loans to such rates could deter borrowers from defaulting and increase collections from those who do.

The Higher Education Amendments of 1986 authorized the creation of a National Student Loan Data System to provide the Department and guaranty agencies with improved information on student loan indebtedness. Once established, agencies could (1) verify borrower eligibility information to preclude double borrowing and (2) ensure that students are not in default on another loan. The Department is beginning to develop the system, but believes it would be more effective if guaranty agencies were required to use the system for verifying borrower eligibility (current law makes its use optional). The Department's Office of Inspector General estimated such a requirement could potentially save

$8.3 million annually in overawards to borrowers committing fraud or already in default.

Tax Refund Offset Successful

The Deficit Reduction Act of 1984 allowed the Internal Revenue Service to offset delinquent debts owed to the government on student loans against defaulters' income tax refunds for tax years 1985 and 1986. For 1985, the Department received about $38 million in refund offsets from individuals with defaulted guaranteed student loans. Extending the program beyond the 1986 tax year requires new legislation, which has been introduced in the 100th Congress.

Share All Payments

Before 1986, Department of Education regulations required that guaranty agencies share all default payments made on reinsured loans with the Department, except that agencies' could retain up to 30 percent to offset collection costs. The Consolidated Omnibus Budget Reconciliation Act of 1985 requires that defaulters have reasonable collection costs added to their debt. The revised regulations allow guaranty agencies to retain 100 percent of payments made to offset reasonable collection costs to provide agencies with an incentive to enhance their collection efforts. However, the agencies also continue to retain 30 percent of the remaining default payments. To maximize its return on defaulted claims paid, the Department should again require that all default payments—including those made to offset collection costs—be shared with the Department.

Follow Federal Collection Standards

The Federal Claims Collections Standards, which federal agencies generally must follow, require that: (1) debts should be paid in one lump sum or, if this is not possible, (2) loan repayment periods for delinquent borrowers should generally be limited to 3 years, and that (3) payments be applied first to all penalty and administrative costs, then to interest, and lastly to principal. While the Department enforces the 3-year repayment limit on loans it directly collects, it permits guaranty agencies to allow longer periods. GAO found that 67 percent of the 616 borrowers it analyzed had repayment periods exceeding 3 years. In addition, the Department requires that defaulters' payments be applied to interest and principal before other collection costs. Limiting repayment periods to 3 years and requiring payments to be applied to interest and other collection costs before principal could increase and hasten default recoveries to the Department.

Remit Collections More Quickly

Fifty guaranty agencies use private collection contractors. Of these, 48 agencies receive contractors' default collections within 1 month of collection, which includes contractors in 28 agencies who remit collections at least biweekly. In addition, the Department makes its collection contractors remit default payments within 1 day of collection. However, guaranty agencies are allowed up to 60 days after receipt to remit default collections to the Department. Reducing the current time frame to 30 days could save over $1 million annually in interest costs and $16 million in additional collection receipts in the first year of implementation.

Recommendations

GAO makes several recommendations to the Congress and the Secretary of Education, which could reduce the federal government's costs. The Congress should (1) increase defaulting borrowers' loan interest rates; (2) require guaranty agencies to use the National Student Loan Data System; and (3) continue, for an additional 2 years, the income tax refund offset program for student loans. The Secretary should revise the program's regulations to require that guaranty agencies (1) share all default payments with the Department; (2) remit these payments within 30 days of receipt; and (3) follow procedures comparable to federal collection standards, such as applying default payments to collection costs and interest before principal.

Agency Comments

The Department of Education generally concurred with GAO's recommendations and said it would begin implementing those not needing congressional action. It noted, however, that workable methodologies will need to be developed before implementing some measures, such as the method of sharing all agency collections with the Department.

The Internal Revenue Service supported an extension of the income tax refund offset program for 2 years. It said permanent program extension should await the results of ongoing studies which will measure the impact on voluntary tax compliance by those who are offset.

The National Council of Higher Education Loan Programs, Inc., responding for the guaranty agencies, generally opposed GAO's recommendations. According to the Council, the recommendations would result in (1) significant data processing changes, (2) pose administrative difficulties for guaranty agencies and their collection contractors, and (3) create repayment disincentives for defaulters.

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Abbreviations

FISL	Federally Insured Student Loan
GAO	General Accounting Office
GSL	Guaranteed Student Loan
IRS	Internal Revenue Service
OIG	Office of Inspector General
PLUS	Parents Loans for Undergraduate Students
SLS	Supplemental Loans for Students

Introduction

Debts owed the federal government are generated by numerous activities—from education loans to import duties to mineral royalties. Most of these receivables result from direct and guaranteed loans. As of September 30, 1986, loans guaranteed by the government, which represent potential receivables that may require future collections, were $450 billion. When these amounts are not paid or payment is late, the government is deprived of the current use of funds, its losses due to bad debts increase, and its administrative workload goes up.

The Guaranteed Student Loan Program is administered by the Department of Education with the assistance of 58 guaranty agencies who manage the program in each state or territory. Through fiscal year 1986, the program has provided over $60 billion to students pursuing a postsecondary education. During the same period over $4 billion has been paid to lenders in default claims for borrowers who failed to repay their loans.

We were asked by Congressman William D. Ford, as Chairman of the Subcommittee on Postsecondary Education, House Committee on Education and Labor, to examine what guaranty agencies are doing to protect the federal government's interest in collecting defaulted student loans. As such, we were asked two questions:

- What collection practices and procedures do guaranty agencies follow in collecting defaulted student loans?
- Are there ways to reduce default costs?

This is the second report provided to the Subcommittee on this request. The first report, issued on July 17, 1986, was a summary of the collection practices and procedures followed by the 58 guaranty agencies. (See Defaulted Student Loans: Guaranty Agencies' Collection Practices and Procedures [GAO/HRD-86-114BR].)

Guaranteed Student Loan Program

The Guaranteed Student Loan Program is the largest federal program providing financial assistance to students seeking a postsecondary education. It began operations in 1965 and has expanded rapidly in the last 5 years. Under this program, various lenders, such as commercial banks and savings and loan associations, make low-interest loans to students

under the protection of guarantees issued by 58 state or private nonprofit guaranty agencies.[1] In fiscal year 1986 alone, the program provided over 3.6 million loans totaling $8.6 billion.

Role of Guaranty Agencies

The guaranty agency is responsible for administering the program within the state, encouraging program participation by lenders, and verifying that lenders exercise prudent lending practices ("due diligence") in making, servicing, and collecting on student loans. These practices were required to be at least as extensive and forceful as those generally practiced by financial institutions for consumer loans.

The agency also issues guarantees on qualifying loans. When a borrower fails to repay the loan due to death, disability, bankruptcy, or default, the guaranty agency pays the lender's claim. The agency also collects insurance premiums from lenders and attempts to collect directly from the borrowers' loans on which the agency has paid default claims. During fiscal year 1986, guaranty agencies collected an estimated $291 million (including $37 million in income tax refund offsets) from defaulted borrowers.

Before paying a lender's defaulted claim, the guaranty agency offers the lender preclaims and supplemental preclaims assistance. Preclaims assistance is any service, such as telephoning the borrower or helping the lender determine the borrower's current address, that the agency provides to lenders on delinquent loans prior to the loans being legally in default. Supplemental preclaims assistance, on the other hand, is to strengthen the preclaims process by allowing the agencies another chance at trying to get the delinquent borrower into repayment. This assistance, by definition, is provided after the 120th day of delinquency and "must be clearly supplemental" (i.e., additional phone attempts that are not otherwise required) to preclaims assistance.

Once the guaranty agency pays a default claim to a lender, it begins a series of actions to obtain repayment from a borrower. Agencies use a series of written notices—called demand letters—to encourage the borrower to repay. These letters are supplemented by attempts to contact the borrower by phone to reinforce the need to begin or resume payment.

[1]At the time of our review, 47 organizations served as the guaranty agencies for 58 separate reporting units under the program. The number of guaranty agencies differs from the number of reporting units because two large nonprofit agencies serve as the designated guarantor for more than one state.

Guaranty agencies have the option of performing their collection activity in house, contracting out to third parties, or using a combination of both methods. In addition, the agencies may also use other collection techniques, such as litigation and wage garnishment.

Role of the Department of Education

The Department of Education has the authority for administering the program. This includes establishing program guidelines; approving the participation of lenders, guaranty agencies, and schools; and overseeing the operations of the agencies and lenders. The Department makes interest and interest subsidy payments[2] to lenders and reinsurance payments to guaranty agencies to reimburse them for paying lender claims. It now reimburses guaranty agencies for one percent of the total principal amount of loans guaranteed to help defray the agencies' administrative costs, which is commonly referred to as the administrative cost allowance. It also provides advances—interest free loans—($205 million since inception of the program) to help the agencies strengthen program reserves and pay lenders' claims. To partially offset program costs, the Department charges borrowers loan origination fees, which lenders collect from borrowers' loan proceeds. The Department also receives a portion of the guaranty agencies' defaulted loan collections that it reinsured. The Department's portion of defaulted receipts is referred to as the "Secretary's equitable share," which must be remitted to the Department within 60 days of receipt by the guaranty agencies. For fiscal year 1986, the Department received about $200 million in such default collections from guaranty agencies.

The Department oversees the activities of guaranty agencies primarily through three different entities: audits by the Office of Inspector General (OIG); program reviews conducted by the Division of Audit and Program Review; and special studies conducted by the Division of Quality Assurance. OIG is the focal point for independent review of the integrity of the Department's operations. OIG's primary objective is to assist departmental management by providing information, analyses, evaluations, and recommendations applicable to management's duties and objectives.

[2]While the student borrower is in school, the lender receives a base interest rate—currently 8 percent—on the loan from the Department. During the life of the loan, the Department also pays the lender an interest subsidy ("special allowance") if needed to compensate the lender for the difference between the program's base interest rate and market rates.

The Division of Audit and Program Review conducts on-site program reviews of guaranty agencies, mainly by using staff from the Department's regional offices. During fiscal years 1985 and 1986 the division conducted 29 and 10 such reviews, respectively. According to Department officials, the small number of reviews completed in 1986 was due to a shortage of travel funds. These reviews are limited in scope, take about 1 week, usually involve one or two staff members, and predominately focus on agencies' procedures for paying default claims and timeliness in remitting to the Department its share of default collections.

The Division of Quality Assurance is part of the Department's Debt Collection and Management Assistance Service. This organization provides leadership and direction to the Department for credit management and debt collection. As part of this unit, the division has specific responsibility for conducting studies of guaranty agency and lender activities. These studies focus on the potential payment errors made in awarding, servicing, and collecting guaranteed student loans. The studies also determine whether corrective actions are needed and, if necessary, how such actions could be implemented.

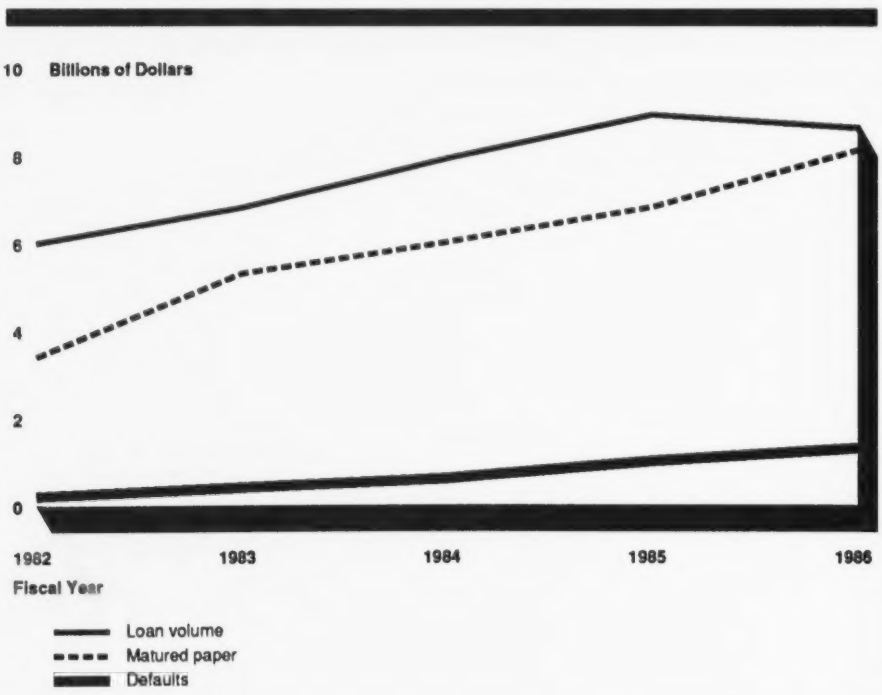
Loan Default Costs Are Increasing

One of the most important concerns in the Guaranteed Student Loan Program is the escalation of default costs. During fiscal years 1982-1986 the annual loan volume, matured paper (the cumulative dollar amount of loans that have entered repayment), and default costs have been closely interrelated, although loan volume dropped slightly during fiscal year 1986. As more money has been loaned and more loans matured, there has been a corresponding increase in the dollar amount of defaults. (See fig. 1.1.)

Figure 1.1 does not include loans made under the Federally Insured Student Loan (FISL) program.[3] No loans have been made under this program, which is part of the Guaranteed Student Loan Program, since July 1984 because of the ready availability of loans guaranteed by the agencies. As shown in figure 1.1, default costs exceeded $1 billion in fiscal year 1986. In addition, Department officials have estimated that defaults could be about $2 billion per year by fiscal year 1990.

[3]Under the FISL program, lenders made loans to student borrowers. However, these loans are directly guaranteed by the federal government and not by guaranty agencies. As a result, if a borrower defaulted, the government attempts to collect the loan.

Figure 1.1: Comparison of Annual Loan Volume, Matured Paper, and Default Costs (Fiscal Years 1982-86)



Objectives, Scope, and Methodology

Our overall objectives were to (1) develop information on the practices and procedures that guaranty agencies follow in collecting defaulted loans and (2) determine whether there are ways to reduce default costs. As a result of subsequent discussions with the Subcommittee, we also agreed to examine (1) how much time defaulters are given to repay their loans and (2) whether the guaranty agencies were remitting the Department's portion of collections within the 60-day timeframe (grace period) required by federal regulations.

As part of our review, we sent questionnaires to all 58 guaranty agencies to obtain information on their organization and the policies and procedures they follow in collecting defaulted loans. The questionnaire contained 126 questions covering such areas as (1) the techniques used to locate borrowers, (2) how private collection contracts are awarded, monitored, and evaluated, (3) when and how agencies choose to use litigation against borrowers, and (4) what administrative offsets/garnishment practices are used to collect on the defaulted loans. All 58 agencies

completed the questionnaire and the results were reported in our July 1986 report (GAO/HRD-86-114BR, July 17, 1986).

To supplement the information gathered through the questionnaire responses and to help validate that the agencies' responses accurately described their collection practices and procedures, we conducted on-site fieldwork at eight judgmentally selected guaranty agencies: Georgia, Louisiana, Maine, Massachusetts, Virginia, Washington, the Higher Education Assistance Foundation, and the United Student Aid Funds, Inc. The Higher Education Assistance Foundation was the guarantor for the District of Columbia, Kansas, Minnesota, Nebraska, West Virginia, and Wyoming. The United Student Aid Funds was the guarantor for American Samoa, Arizona, Guam, Hawaii, Northern Marianas, and the Trust Territories. (We conducted our on-site fieldwork for the latter two organizations at their headquarters only.)

The first six agencies above were chosen by considering such factors as the (1) number of loans guaranteed, (2) rate which lenders were paid for defaulted loans when compared to the number of loans guaranteed, (3) rate at which guaranty agencies were able to subsequently collect defaulted loans, and (4) costs that agencies incurred in collecting defaulted loans. We chose the other agencies because they are the only two which operate nationwide. Figure 1.2 shows the states covered by our review.

According to Department records, during fiscal year 1985 the eight agencies we selected paid over 75,000 defaulted claims, worth approximately $208 million, to lenders. These figures represent about 23 percent of the claims and 22 percent of the dollar amount paid to lenders for defaulted loans during the year.

We selected individual borrower files to determine (1) the characteristics of defaulted loans in repayment and (2) whether guaranty agencies were remitting the Department's portion of collections within the 60-day grace period. To determine the characteristics, we randomly selected a sample of 100 defaulted claims paid by each of the eight agencies during fiscal year 1985, which were subsequently being repaid by borrowers. We drew our sample from cases meeting the Department of Education's definition of a borrower in repayment: a borrower is considered to be in repayment if he or she had made a payment to the guaranty agency within the last 120 days.

Figure 1.2: States Included in GAO's Review of the Guaranteed Student Loan Program

We first determined that the sample met the Department's criteria for a borrower in repayment. We then applied our own criteria and only selected claims in which the borrower made repayment arrangements with the guaranty agency or the private collection agency handling the account. We excluded borrowers who had (1) made a payment without establishing repayment arrangements, (2) died, or (3) made their initial

payment or had their claim reinsured by the Department after December 31, 1985—the cutoff date for our analysis.

After considering these exclusions, we had a sample of 616 cases from the 800 we randomly selected. Because these exclusions reduced our sample size significantly, we limited our analysis and discussion of the results to those cases selected, rather than projecting the characteristics to all agency loans in repayment.

At each agency we examined the practices and procedures it followed in collecting defaulted loans. We conducted interviews with agency personnel knowledgeable with the collections function, as well as with certain other officials. We focused our work on determining (1) how long defaulters were given to repay their loans and (2) whether the guaranty agencies had remitted the Department's share of collections within the required 60-day timeframe.

We reviewed the repayment history of those borrowers selected and recorded data on the repayment agreements and the timeliness of payments made by the borrowers by December 31, 1985. Using this cutoff date allowed each agency at least 60 days to remit to the Department its share of collections before we began our fieldwork. (See chapter 4 for a discussion of this regulatory requirement.) Our work began in March 1986 and ended in January 1987.

At Department of Education headquarters in Washington, D.C., we accumulated statistics on defaulted loans for each agency in the program, examined the controls that the Department has for managing default collections, and reviewed the Department's most recent reports and studies of the guaranty agencies. We held discussions with Department officials responsible for program policy, administration, and guaranty agency reviews. We also discussed the results of our work at the guaranty agencies with Department officials.

We analyzed the legislation and regulations that pertain to the guaranty agencies, including the legislative history concerning agency collections. During the course of our work many legislative and regulatory changes were made to the Guaranteed Student Loan Program, including changes that were intended to improve default prevention and postdefault collection procedures. Most of these changes came from the (1) Consolidated Omnibus Budget Reconciliation Act of 1985 (Public Law 99-272) and (2) Higher Education Amendments of 1986 (Public Law 99-498). (Appendixes I and II contain examples of the major changes these laws

made to the Guaranteed Student Loan Program.) In addition, the Department also issued new program regulations on November 10, 1986. We analyzed the new laws and regulations to determine the potential impact they may have on the program. Subsequent to the completion of our work, on June 3, 1987, the Higher Education Technical Amendments Act of 1987 (Public Law 100-50) was enacted. This law modified certain technical and conforming changes made by previous legislation. Because the technical amendments were enacted after we completed our work, we have not analyzed the effects of these changes in this report.

The OIG conducted two assignments recently concerning the collection of defaulted student loans. One assignment concerned the effectiveness of guaranty agencies' collection efforts and the other reviewed the timeliness of guaranty agencies' remittance of the Department's share of default collections. The OIG is currently drafting reports on the results of its efforts.

GAO obtained written comments on a draft of this report from the Department of Education (see app. III), the Internal Revenue Service (see app. IV), and the National Council of Higher Education Loan Programs, Inc. (see app. V). The Council represents agencies and organizations—including most guaranty agencies—involved in the making, servicing, and collecting of guaranteed student loans. This review was made in accordance with generally accepted government auditing standards.

Guaranty Agency Collection Practices and Procedures

At the time we completed our fieldwork, the Department's regulations for guaranty agencies to follow in collecting defaulted student loans were very general, thereby allowing each agency to establish and enforce its own collection practices and procedures. Consequently, some collection practices varied widely among agencies. For example, all 58 agencies sent an initial payment demand letter and attempted to contact the defaulted borrower by phone within 45 days after default, but only 24 percent initiated legal action against the borrower within 225 days after default. In addition, although 85 percent of the agencies used the Internal Revenue Service to help locate defaulters, only 19 percent used the state unemployment commission.

In November 1986—after we completed our visits to eight agencies—the Department published new program regulations (the last regulations were issued in 1979) that require more specific collection procedures. These regulations contain five standardized collection steps. (See p. 23.) We found that the agencies' past collection practices and procedures were generally less stringent than these new collection requirements. While it is too early to assess the effectiveness of the new procedures, they should improve agency collections and ensure that guaranty agencies are providing a minimum level of effort on each defaulted loan. Agencies are also required to enter into litigation (when cost-effective) against all borrowers who have the financial ability, but not the desire, to repay.

In addition, the new regulations provided for mandatory recall of defaulted loans from guaranty agencies if the Department determines that such assignment is necessary to protect the federal government's interest. The success of mandatory assignment, however, would depend on the criteria used to determine which loans would be reassigned and the level of departmental resources used to collect the loans.

Collection Practices and Procedures Before Revised Regulations

The Department's previous regulations required that the guaranty agencies use generally accepted consumer loan collection practices, including litigation as appropriate, in collecting loans on which default claims had been paid to lenders. The regulations did not specifically define what these procedures should include; rather, they provided for guaranty agencies establishing their own collection procedures. As a result, we found variances in the agencies' collection practices and procedures.

Questionnaire Results on Collection Practices

The agencies use various resources to locate borrowers. As shown in table 2.1, most agencies used address information obtained from the Internal Revenue Service, the U.S. Postal Service, and credit bureau reports to help locate defaulted borrowers, but few agencies used state organizations, other than the departments of motor vehicles, for such location assistance.

Table 2.1: Resources Used by Guaranty Agencies to Locate Borrowers

Resources	Percent
Federal agencies	
Internal Revenue Service address location assistance	85
U.S. Postal Service	71
Other federal agencies	19
Credit bureau	
Reports from borrowers' credit history	74
State organizations	
Department of motor vehicles	79
Department of taxation	29
Department of personnel	21
Unemployment commission	19
Military reserves	14
Voter registration	10

Seventy-four percent of the agencies had an in-house collection unit and almost all of these agencies supplemented their efforts by using private collection contractors. The number of collection firms used averaged 5, ranging from 1 to 20. The agencies used private collectors for an average of 9 years, ranging from 1 to 22 years.

All guaranty agencies stated they take legal action against borrowers if needed; however, 79 percent had problems enforcing a legal judgment once it was obtained. Figure 2.1 illustrates the major problems the agencies said they had when trying to enforce judgments.

Guaranty agencies differed in what they believe are their most successful collection techniques. The most successful technique cited by 29 percent of the 55 agencies that responded to this question, was reporting borrowers to credit bureaus. Other successful techniques are shown in the table 2.2. (Agencies could cite more than one technique. Techniques cited by less than 9 percent of the agencies are excluded.)

Figure 2.1: Problems Guaranty Agencies Have When Enforcing Judgments

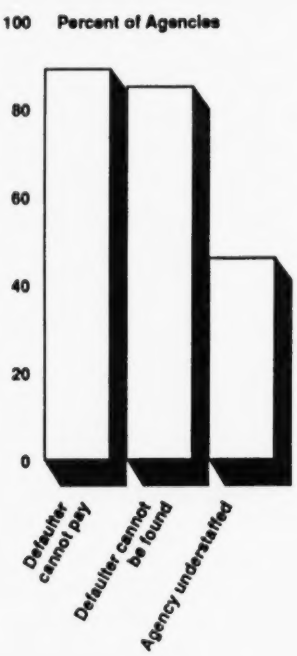


Table 2.2: Successful Collection Techniques Used by Guaranty Agencies

Collection techniques	Percent
Reporting to credit bureaus	29
Use of collection contractors	25
Personal contact with borrower	25
Litigation/threat of litigation	13
Long-term payment arrangements	11
Federal income tax refund offsets	11
State income tax refund offsets	11
Wage garnishments	9

Site Visits' Results

We visited eight agencies to validate the reasonableness of information gathered through the questionnaire responses. In addition, we wanted to obtain more information about the agencies' collection practices and procedures to supplement our questionnaire results. For example, we asked the eight agencies whether they established a minimum monthly

payment amount that they would accept from a borrower that wanted to repay. Two agencies specified no minimum amount, while the others ranged from $5 to $200. In addition, we also wanted to know whether the eight agencies limited the time over which defaulted borrowers have to repay their loans in full. These maximum payback periods ranged from no maximum in five agencies, to 5 years in one agency, and to 10 years in the other two agencies. Other examples of collection procedures that were followed by the eight agencies are shown in table 2.3.

Table 2.3: Examples of Procedures Used to Collect Defaulted Loans

Procedure	Number of agencies using procedure
Initial collection attempt by:	
In-house collectors	5
If debtor refuses to pay, account assigned to:	
Private collection agency	4
Private law firm	1
State attorney general	1
Private collection agency or state attorney general	2
If borrower cannot be located, account is:	
Referred to collection contractor	6
Kept in-house for additional work	2

The five agencies that initially attempt in-house collection may eventually refer the accounts to a contractor if the borrower becomes unresponsive, or after a certain period of time has elapsed and the borrower was not making or stopped making payments.

Five agencies plan to expand their in-house collection staff and one plans to establish an in-house collection unit. Their main reason for expanding or establishing an in-house collection effort was their belief that it was more economical to attempt collection before assigning the account to a contractor. Those agencies with in-house collectors had from 4 to 24 collectors, each averaging between 297 and 2,780 accounts.

Department Issues New Program Regulations

The Department's revised program regulations should have a significant impact on strengthening the collection procedures of the guaranty agencies. Two of the more important parts of these regulations concern standardized collection procedures and the mandatory assignment or recall of defaulted loans to the Department.

Standardized Collection Procedures

We found that the agencies' past collection practices and procedures were generally less stringent than the Department's new collection requirements. In contrast to the prior general requirements, the guaranty agencies must now follow five minimum collection steps within specific intervals after the date the agency paid a default claim submitted by a lender. Table 2.4 shows the percentage of agencies whose past procedures would have met the Department's new requirements.[1]

Table 2.4: Comparison of Guaranty Agencies' Collection Procedures vs. Department's Proposed Standards

	Collection standards	
Number of days	**Procedures**	**Percent**
45	Written notice and phone attempt	100
90	Written notice, phone attempt, and report to credit bureau	53
135	Written notice and phone attempt	71
180	Final written notice	43
225	Civil suit initiated	24

The final regulations include the five collection steps in table 2.4. In the draft regulations, the last step required that a guaranty agency initiate legal action (litigation) against nonpaying defaulted borrowers between 181 and 225 days after a lender had been paid. As shown in figure 2.1, this requirement could have resulted in a proliferation of lawsuits and judgments that may not have been enforceable. For example, 89 percent of the 46 agencies who said they have problems enforcing a judgment, said the borrower does not have the ability to repay. The Department subsequently modified the litigation requirement in its final regulations by requiring that guaranty agencies must still initiate legal action within 181 to 225 days, but only if (1) using litigation would be cost-effective and (2) the borrower has the financial ability to pay a substantial portion of the judgment. If a borrower does not have the ability to pay, the guaranty agency is required to semiannually redetermine the borrower's ability to satisfy a judgment.

The Secretary of Education stated in the final regulations that litigation and the other standardized collection steps "reflect the minimal level of effort necessary to protect the Federal interest in diligent loan collection."

[1]Our comparison was based on the procedures that were in the Department's draft regulations, which were subsequently incorporated in regulations issued on November 10, 1986.

Mandatory Assignment of Defaulted Loans

Section 682.409 of the new regulations concerns mandatory assignment by guaranty agencies of defaulted loans to the Secretary. Part (a) states that

"When the Secretary determines that such action is necessary to protect the Federal fiscal interest, the Secretary may direct a guarantee (sic) agency to assign to the Secretary for collection a defaulted loan on which the Secretary has made a payment under sections 682.404 or 682.405. In making this determination, the Secretary considers all relevant information available to the Secretary, including any information and documentation submitted by the guarantee (sic) agency."

The Department believes that mandatory assignment will facilitate the use of the most effective, cost-efficient collection methods available. For example, it stated that the federal government has collection tools that are not available to guaranty agencies, such as offsets of debts against federal income tax refunds. It added that one of the main factors the Secretary intends to consider in determining which loans will be recalled is the relative cost-effectiveness of agency collection efforts compared to those used by the Department.

The Department initiated a pilot study in September 1987 to develop its criteria for determining which loans may be subject to this mandatory assignment process. The Department is also determining the level of staff resources and computer enhancements necessary to begin recalling loans from guaranty agencies.

Conclusions

The Department's new program regulations should better protect the federal government's interest than did the earlier regulations. For example, the five standard collection steps, if properly implemented by the agencies and monitored by the Department, should (1) provide assurance that a minimum level of effort is performed on every defaulted claim reinsured by the Department and (2) bring closure through litigation on borrowers who have the ability, but not the desire to repay. These steps do not preclude an agency from doing more to try and resolve each account. Although collections should increase, it is too early to estimate the effect these new criteria will have on collecting defaulted loans.

The provision for mandatory assignment of defaulted loans to the Department should also provide the guaranty agencies with a performance incentive. If an agency is not performing well, it could have some or all of its defaulted loan portfolio recalled by the Department. How

effective this provision will be depends on (1) what criteria the Department will use in determining which defaulted loans are subject to this mandatory assignment and (2) whether the Department will have sufficient resources to adequately handle an increased workload.

How Much Time Are Defaulters Given to Repay Their Loans?

In the private sector, when borrowers become delinquent, creditors generally contact them quickly to determine the reasons for nonpayment and encourage immediate resumption of payments. For those borrowers who fail to resume payment, creditors can demand immediate payment of the entire debt or—if the borrower is unable to pay in one lump sum—arrange for accelerated payments.

Similarly, federal agencies collecting debts owed to the government generally follow the Federal Claims Collection Standards, which require that defaulters repay in one lump sum or, if payment must be made in installments, the debt should be liquidated in no more than 3 years if possible. The Department of Education follows these guidelines for defaulted loans it holds, but has no similar requirement for guaranty agencies, who establish their own repayment guidelines. Because guaranty agencies can receive 100 percent reinsurance for default claims paid to lenders (and up to 35 percent of any subsequent payments by defaulters), they lack strong incentives to limit repayment periods.

Sixty-seven percent of the borrowers in our sample had scheduled payment arrangements, which will take more than 3 years to repay their defaulted loans. As a result, the Department might not be reimbursed for its losses on reinsured loans as quickly as it could be. We believe the Department should require guaranty agencies to follow criteria comparable to the federal standards, which state that delinquent debts should be repaid in no more than 3 years, if possible.

Characteristics of Defaulted Loans in Repayment

No federal guidelines exist specifying how long a defaulter should be given to repay a defaulted guaranteed student loan. Such guidance is important to ensure prompt payment of defaulted loans and timely remittance of the Department's share of collections. Thus, we wanted to know how long agencies allow defaulters to repay their loans. Other information we collected on borrower repayment practices concerned the following:

- What was the amount of each default claim?
- How long did borrowers take to make their first payment?
- How much were borrowers paying per month?
- Were payments made in the agreed upon amount?
- Were payments received on time?
- Are debtors current on their repayment agreements and if not, why?

All 616 borrowers in our sample had established monthly repayment arrangements with the guaranty agencies. Our analysis of these arrangements and the borrowers' repayment histories follow.

Seventy percent of defaulters' claims were $3,000 or less.

Table 3.1: Dollar Amount of Claim Paid to Lender

Dollar amount	Percent[a]
$1 to 1,000	10
1,001 to 2,000	23
2,001 to 3,000	37
3,001 to 4,000	6
4,001 to 5,000	7
Over 5,000	16

[a]Percentages may not add to 100 due to rounding.

Seventy-four percent of borrowers who do pay, make their initial payment after default within 4 months.

Table 3.2: Days Elapsed Before Borrower Made Initial Payment

Number of days	Percent
1 to 30	9
31 to 60	20
61 to 90	28
91 to 120	17
Over 120	26

Most defaulters will take more than 3 years to pay off their loans.

Table 3.3: Number of Months Needed to Repay Defaulted Loans

Number of months	Percent[a]
1 to 12	5
13 to 24	14
25 to 36	15
37 to 48	19
49 to 60	17
Over 60	31

[a]Percentages may not add to 100 due to rounding.

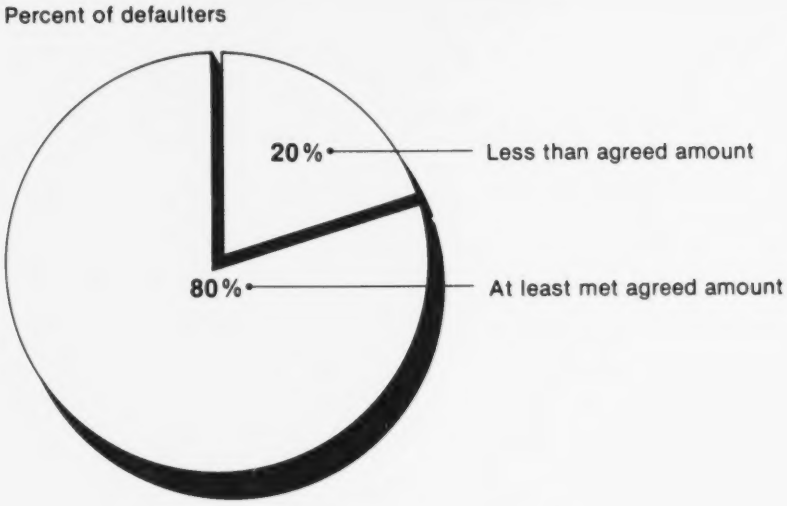
Most defaulters will pay $60 dollars or less per month.

Table 3.4: Monthly Repayment Amount on Defaulted Loans

Dollars per month	Percent
$1 to 20	5
21 to 40	18
41 to 60	42
61 to 80	11
81 to 100	13
Over 100	11

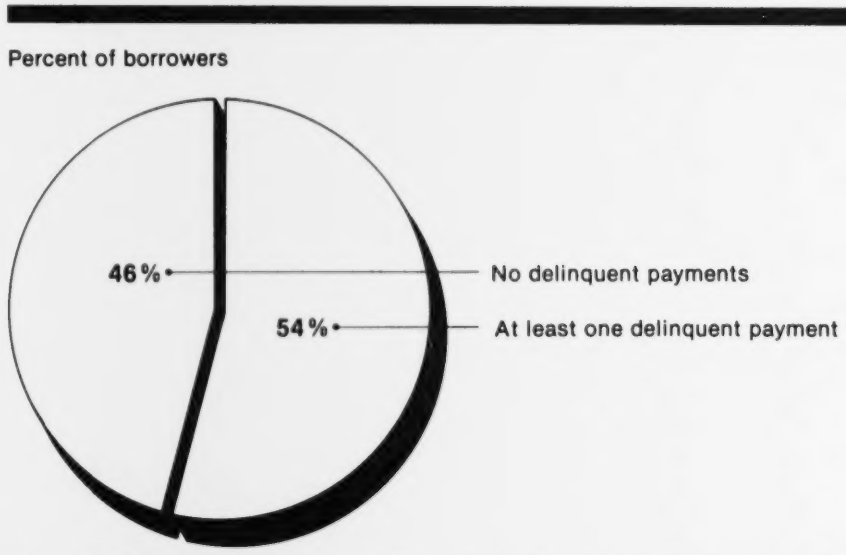
Eighty percent of the payments at least met the agreed monthly payment amount.

Figure 3.1: Payment Met or Exceeded the Agreed Payment Amount



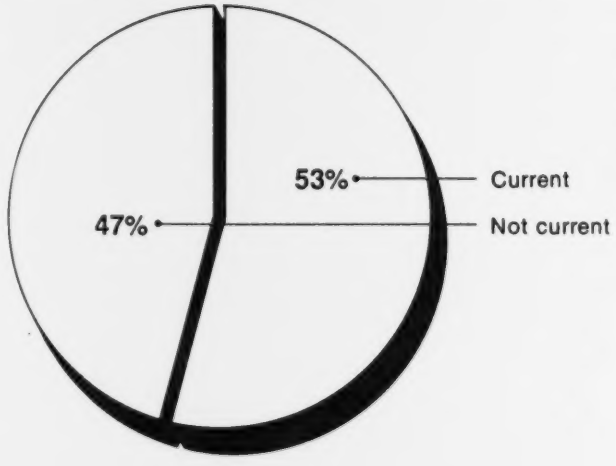
However, 54 percent of the borrowers had at least one delinquent payment.

Figure 3.2: Borrowers Who Had Delinquent Payments



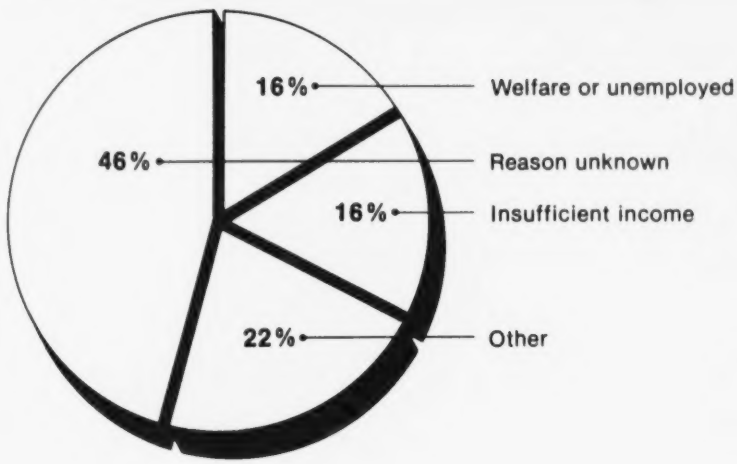
Those delinquent payments may have contributed to 47 percent of the borrowers being behind in their payments.

Figure 3.3: Borrowers That Were Current on Their Payments



Yet in 46 percent of the cases, the agencies or their collection contractors could cite no apparent reason for the delinquency.

Figure 3.4: Reasons Cited for Borrowers Being Behind on Their Payments



Federal Agencies Have Repayment Criteria

Federal agencies collecting debts owed them must generally follow procedures that are contained in the Federal Claims Collection Standards. These standards, commonly referred to as the "Joint Standards," are regulations jointly issued by GAO and the Department of Justice. Agencies are required to follow the standards when there are no other laws or regulations specifically applicable to their collection activities.

The Joint Standards state that when feasible (and except as otherwise provided by law), delinquent debts should be collected in one lump sum. The standards also state that if a debtor is unable to pay in one lump sum, payment may be made in regular installments. In addition, the standards state that "If possible, the installment payments should be sufficient in size and frequency to liquidate the Government's claim in not more than three years."

Although not specified in their program regulations, Department of Education officials told us the Department follows the Joint Standards in collecting defaults under the FISL and National Direct Student Loan Programs—renamed the Perkins Loan Program by the Higher Education Amendments of 1986. Department officials stated that these standards

will be specified in a debt collection regulation currently in final clearance within the Department. The Department also requires its private contractors to follow the Joint Standards in collecting defaulted loans under these two programs.

Guaranty agencies, in essence, operate as contractors in collecting defaulted student loans. Although the Department follows the Joint Standards, it has no requirement that guaranty agencies use similar standards or similar procedures in their collection activities.

Conclusions

Guaranty agencies can specify their own criteria on how long a period of time to give borrowers with defaulted loans to repay their debts in full. Although two-thirds of the borrowers in our sample will take more than 3 years to repay their debts, we performed no evaluation of whether the repayment arrangements made were the optimum possible at that time. Nonetheless, we believe the Department should develop guidelines for the guaranty agencies specifying criteria—such as those it follows in accordance with the Joint Standards—for repaying defaulted loans in installments.

Recommendation

We recommend that the Secretary of Education amend the regulations for the Guaranteed Student Loan Program to require that guaranty agencies adhere to criteria comparable to the Joint Standards, which require that, if possible, defaulted debts paid in installments be paid off in 3 years or less.

Agency Comments and Our Evaluation

Department of Education

In a letter dated September 11, 1987, the Assistant Secretary for Postsecondary Education stated that the Department concurred with our recommendation.

National Council of Higher Education Loan Programs, Inc.

In comments dated September 18, 1987, the Board of Directors of the National Council of Higher Education Loan Programs, Inc., stated that it cannot support a regulatory requirement that the repayment period should be shortened to 3 years. According to the board, a repayment timeframe of 3 years or less could be a disincentive for some borrowers to enter repayment.

Our recommendation that the guaranty agencies adhere to criteria comparable to the Joint Standards would not, in itself, create a disincentive for borrowers to enter repayment. Under such criteria, guaranty agencies could arrange longer repayment terms if a defaulter had no financial means of repaying the debt in 3 years. Rather, our recommendation is designed to encourage guaranty agencies to establish prompt repayment schedules while providing them the flexibility to tailor the repayment period to meet the defaulter's current financial situation.

Guaranty Agencies Need to Remit Collections More Quickly to the Department

Guaranty agencies are required to remit the Department of Education's portion of default collections on reinsured loans within 60 days after receipt. We found, however, that the agencies are not always prompt in their payment to the Department. Twenty-four percent of the borrowers' payments received at eight agencies we visited were not transmitted to the Department on time. When agencies do submit their payments late, the Department has no procedures for penalizing them. In comparison, federal agencies must pay an interest penalty when they pay their bills late.

Although the Department allows guaranty agencies 60 days to remit default collections, the Department requires its own collection contractors working on other loan programs to remit default payments daily. Further, 17 of the 50 guaranty agencies using collection contractors have payments remitted weekly and another 11 agencies have payments remitted at least biweekly. Thus, it appears that reducing the timeframe for agencies to remit collections to the Department is feasible and doing so would save the Department money. For example, if the period had been reduced by 30 days in fiscal year 1986, the Department would have increased its collections income by $16 million, and saved over $1 million in interest costs.

Agencies Are Not Always Timely in Remitting Collections

Federal regulations stipulate that guaranty agencies are to submit the Department's share of default collections on reinsured loans within 60 days of receipt. The beginning date for this period starts on the date the borrower's payment was received by either the agency or its collection contractor. Our analysis of defaulted loan payments showed that each of the eight agencies we visited had payments that were submitted late. Table 4.1 shows that 24 percent of the payments were late and 16 percent were remitted within 30 days.

Table 4.1: Number of Days Taken to Remit Default Payments

Number of days	Percent of payments
1 to 30	16
31 to 60	60
61 to 70	13
71 to 80	6
81 to 90	1
Over 90	4

The guaranty agencies cited three major reasons why some of their payments were late

- flaws in their computer software caused some payments to be excluded,
- private contractors delayed submitting collections, and
- the 60-day period was miscalculated by using the date an agency received the payment from a contractor as the beginning of the period.

No Penalty Exists for Late Payments

Guaranty agencies can take more than 60 days to remit the Department's share of collections, if approved by the Secretary of Education. However, according to a Department official responsible for overseeing the collection submissions by the agencies, no agency has ever been granted a waiver from this 60-day requirement. The official added that the Department periodically checks the agencies' submissions for timeliness. If an agency is late, the Department may send it a form letter encouraging it to be more timely.

The Department's regulations do not contain provisions for assessing penalties on agencies who submit the Department's share of collections late. Department officials have recognized the need for such provisions, but say they have had insufficient time to fully explore such a regulatory change because of other priorities. Thus, agencies have no financial incentive to pay on time, and the Department lacks a practical penalty to enforce timely payment.

Federal Payment Policies More Stringent

The Prompt Payment Act (Public Law 97-177) governs the federal government's responsibilities in paying its bills in a timely manner. It requires that federal agencies acquiring property or services from a business concern must pay as agreed. If an agency does not pay on time, it must pay an interest penalty to the business concern. The penalty is generally required if payment for the item is made 15 days after the payment is due.

The law also states that the interest penalty unpaid after any 30-day period is added to the principal amount of the debt. Any penalties accruing thereafter are on the increased principal. The interest rate to be paid by the government on any late payment is determined by the Secretary of the Treasury, in accordance with the Contract Disputes Act of 1978 (Public Law 95-563). The interest rate for 1987 is 7 percent.

Sixty Days Is Too Much Time

The 60-day period is also much longer than the Department allows its collection contractors. These contractors, collecting on defaulted FISL and Perkins Loans, must submit collections daily. They must generally deposit their payments in the nearest Federal Reserve Bank within 24-hours of receipt. In addition, the Department's regulations for the Perkins Loan Program require contractors, working directly for the schools, to deposit collections "immediately upon receipt" in the school's bank account. (The schools are the creditors under this loan program.)

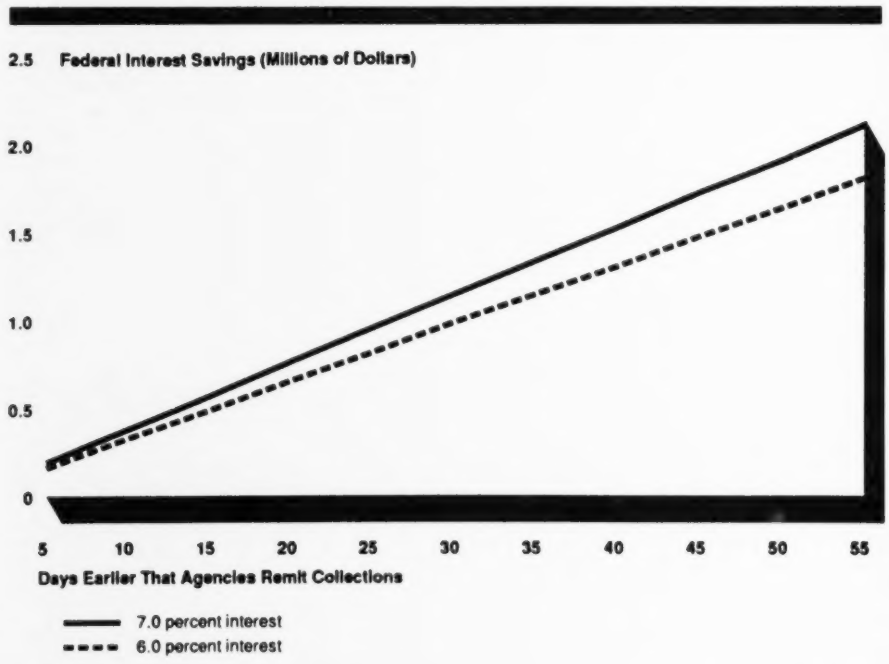
We found that of the 50 guaranty agencies using collection contractors, 17 have contractors forward collections to the agency weekly, 11 remit biweekly, 20 remit monthly, and 2 agencies use some other timeframe. Nonetheless, some parties maintain that more than 60 days is needed to forward default collections to the Department. For example, several of those who commented on the Department's draft regulations suggested that agencies using collection contractors would have difficulty remitting the Department's share within 60 days. They suggested that an agency should be given an additional 30 days from the time the contractor receives a borrower's payment. The Department retained the 60-day period and said that—"Sixty days is a sufficient period for a guaranty agency to perform the administrative functions necessary to account for and remit the Secretary's equitable share."

Interest Savings Are Possible

If the 60-day period were reduced, the Department would receive its portion of collections faster and the federal government would realize interest savings because of reduced borrowing requirements. The amount of such savings would depend on (1) the reduction in the grace period, (2) the amount collected per year, (3) the average annual government interest cost, and (4) the degree of compliance. For example, during fiscal year 1986, the Department received $200 million in default collections from guaranty agencies. Potential interest savings—using grace periods of various day's length and Treasury bill interest rates typical during the last year—are illustrated in figure 4.1. Assuming an annual interest rate of 7 percent and that agencies average 60 days to remit collections, a reduction to a 30-day grace period could have saved the government over $1 million in interest during fiscal year 1986. Similar savings would occur annually.

An additional one-time savings would occur during the fiscal year in which such a change is affected—this would have been $16 million in fiscal year 1986. In essence, the government would get 13 months of collections in the first year.

Figure 4.1: Potential Interest Savings If Agencies Shared Collections Earlier



Conclusions

Although guaranty agencies have no financial incentive for submitting the Department's share of collections on time, they have met the federal requirement 76 percent of the time. However, we believe the 60-day grace period they now have is too long. Reducing the timeframe to 30 days—still significantly longer than the Department allows its collection contractors—should allow agencies using collection contractors sufficient time to remit the Department's share of collections. It is in the federal government's best interest to have the agencies remit their collections more quickly, thereby reducing the government's borrowing costs.

The Department should also develop penalty procedures for those agencies who submit their payments late. Such procedures are representative of the financial management practices of many organizations.

Recommendation

We recommend that the Secretary of Education (1) amend the Guaranteed Student Loan Program regulations to require that guaranty agencies submit the Department's share of collections on reinsured loans within 30 days and (2) explore a mechanism to assess penalties, similar to those included in the Prompt Payment Act, against agencies who submit their payments late.

Agency Comments and Our Evaluation

Department of Education

In a letter dated September 11, 1987, the Assistant Secretary for Postsecondary Education stated that the Department concurred with our recommendation and will begin the regulatory process to implement this change.

National Council of Higher Education Loan Programs, Inc.

In comments dated September 18, 1987, the Board of Directors of the National Council of Higher Education Loan Programs, Inc., stated that default payments could not always be transmitted to the Department within 30 days under the Department's existing monthly payment system. This is because some payments may be received too late in the month (e.g. after the 25th of any month) to be included in that month's submission. In such instances, more than 30 days would elapse before the payments could be included in the next month's submission. The board suggested that a 45-day requirement be used to allow for such end-of-month payments, which would still achieve the goal sought by GAO.

We believe the Department could, in its implementation of our recommendation, include sufficient changes to the existing system to overcome the Board's concern and allow guaranty agencies to submit all default payments within 30 days. For example, the Department could change its system to require (1) a twice monthly payment of guaranty agency collection, or (2) the electronic transfer of payments.

Chapter 5

What Else Can Be Done to Protect the Federal Government's Interest?

As we discussed earlier, a variety of legislative and regulatory changes have strengthened the Guaranteed Student Loan Program's collections and default prevention. Additional changes could further reduce the federal government's cost and risk, and increase program income. Several of these changes would require amending the Higher Education Act of 1965, whereas others could be implemented by the Department revising its regulations. For example, the Congress should increase the interest rate for all new borrowers who default to a variable rate, consistent with the rate charged to nondefaulters, which would help deter defaults while increasing collections for those who repay after default.

The Secretary of Education should require that the Department receive a share of all payments made to guaranty agencies by defaulted borrowers, such as those made to pay reasonable collection costs. The Secretary should also require that guaranty agencies follow specific collection practices similar to those followed by the Department in accordance with the Joint Standards for activities such as the accruing of interest on all unpaid costs for defaulters who fail to abide by their repayment agreements.

In addition, based on its success during the first 2 years, the Congress should provide the Department of the Treasury with authority to continue for another 2 years, the program for offsetting defaulted student loans against borrowers' federal income tax refunds.

Increase Defaulters' Interest Rates

A borrower receiving a subsidized guaranteed student loan (interest is paid by the government) has to pay a loan interest rate of 8 percent since 1983 once he or she completes or withdraws from their course of study. Their payments become due after completing their grace or deferment periods. If the borrower fails to make these payments and subsequently defaults, their loan interest rate remains the same. The law does not provide for any increase to a borrower's loan interest rate upon default. The Higher Education Amendments of 1986, however, provide an increased interest rate (from 8 to 10 percent) for new borrowers obtaining loans on or after July 1, 1988, during their fifth year of repayment. In addition, borrowers obtaining unsubsidized Parents Loans for Undergraduate Students (PLUS) and Supplemental Loans for Students (SLS) for periods of enrollment on or after July 1, 1987, will pay a variable interest rate with a ceiling of 12 percent.

Agencies Required to Charge Highest Interest Rates Allowed

The Department's new regulations require that guaranty agencies charge interest on a reinsured claim at a rate that is the greater of (1) the rate established by the terms of the original promissory note or (2) the rate provided by state law. Some of those who commented on these regulations opposed charging interest to borrowers that default, and the Department responded that the Secretary believes that borrowers should not benefit financially by defaulting. The provision for charging interest to defaulted loans was retained.

Increased Rate Could Deter Defaults and Increase Collection Revenues

Increasing the costs to borrowers who default could act as a deterrent to those who may be thinking of defaulting. If a borrower knew that his or her loan interest rate could potentially increase from 8 to 12 percent upon default, this penalty could be significant enough to make the person begin or resume paying the lender. It would be less costly to the government to prevent defaults, rather than collecting after default. In addition, the federal government would receive additional income from those defaulters who repay. For example, assume an agency receives 100-percent reinsurance on $1,000,000 in defaulted claims from borrowers who had 8 percent loans and subsequently paid the loans off in one lump sum exactly 1 year later. Using simple interest, the federal government would receive $756,000 [the 70 percent equitable share x ($1,000,000 repaid + $80,000 in accrued interest)]. If the interest rate were increased to 12 percent upon default the government would receive $784,000, for a net increase of $28,000.

Limit Garnishment Bonus

The 1986 amendments allow guaranty agencies that are authorized under a state law to garnish a borrower's wages, meeting certain provisions of the amendments, to retain 35 percent of their default collections, rather than 30 percent. The amendments, however, provide no requirement that guaranty agencies actually use garnishment against a borrower to receive the extra 5 percent of collections. As a result, an agency that qualifies for this garnishment bonus could receive this additional 5 percent without ever using garnishment.

We do not know at this time which guaranty agencies would qualify for this additional income. If all agencies had qualified and the bonus was available during fiscal year 1986, however, the agencies could have retained an additional $12.7 million of their collections ($254 million in collection receipts x 5 percent).

On April 27, 1987, we brought this issue to the attention of the Subcommittee on Postsecondary Education, House Committee on Education and Labor, and the Subcommittee on Education, Arts, and the Humanities, Senate Committee on Labor and Human Resources. As a result, a provision was included in the Higher Education Technical Amendments Act of 1987, which requires states to enforce garnishment for guaranty agencies to receive the 5 percent bonus.

Mandate That Guaranty Agencies Use a Student Loan Data Base

The 1986 amendments also authorized the establishment of the National Student Loan Data System—a nationwide computerized student loan data bank containing information on loans made, insured, or guaranteed under the Guaranteed Student Loan and Perkins Loan Programs. The system is intended to provide information on student loan indebtedness and institutional lending practices, as well as help insure compliance with other provisions of the law. Although much of this data is already available from individual guaranty agencies, the system will centralize the information and make it more accessible.

The data system would include information on (1) the amount of each loan made; (2) the name, social security number, and address of each borrower; (3) the guaranty agency; and (4) the institution of higher education that made the loan if it was a Perkins loan. This information would be provided to the Department by the guaranty agency or the school.

The law does not require that the system be established. If the Department does develop the system, however, it is precluded by law from requiring guaranty agencies to use the system to verify borrower eligibility information. If the system is established, guaranty agencies can decide whether to use it to identify ineligible borrowers, such as those who attempt to obtain multiple loans for the same school term or who are already in default on another loan. The Department is developing a plan for establishing the system, but believes the system would be more effective if the Department could require that the guaranty agencies use the system for verifying borrower eligibility. The Department supported such a requirement in legislative proposals it has sent to the Congress.

The OIG estimated in an April 1986 report (Controls Needed to Prevent and Detect Fraud and Abuse of the Guaranteed Student Loan Program) that such a national data system could save an estimated $8.3 million annually from individuals who commit fraud or abuse the program. These savings are the net of the Department's cost for establishing and

operating the system and the guaranty agencies' cost for using it. To realize these savings, the Department must establish the system and then be able to require that guaranty agencies use the system to verify borrower eligibility.

Share All Default Payments With the Department

Before 1986, the Department's regulations required that a guaranty agency "shall pay the Secretary an equitable share of any payment made by or on behalf of a defaulted borrower after the Secretary has reimbursed the agency." The regulations (incorporating the statutory definition) defined the Secretary's equitable share as that portion of a borrower's payment that remains after a guaranty agency has deducted both its reinsurance costs[1] and up to 30 percent to cover its program costs for default collections, to the extent such costs did not exceed 30 percent of payments. The 1986 amendments modified the second provision by allowing guaranty agencies to retain a flat 30 percent of all default collections (and 35 percent if the state has a qualifying garnishment statute as discussed on p. 39).

The Consolidated Omnibus Budget Reconciliation Act of 1985, enacted in April 1986, revised the Higher Education Act to require that defaulters have reasonable collection costs added to their debt. Department officials stated that the addition of such costs is already specified in the promissory notes for all borrowers of guaranteed student loans.

To provide the guaranty agencies with an incentive to enhance their collection effort, Department officials said that the revised regulations have no requirement that payments added to the debt to offset collection costs, such as court costs and attorneys' fees, be shared with the Department. As a result, the guaranty agencies can retain 100 percent of the monies paid to offset reasonable collection costs, and at least 30 percent of the remaining default payments.

The Department could increase its return by requiring that any payment made by a defaulter on a reinsured loan be shared with the Department, as shown in the following two hypothetical examples. In the first example, assume that the Department paid reinsurance on $1,000,000 in claims and that borrowers paid the $1,000,000 immediately. The maximum the Department could receive on these claims would be $700,000,

[1]Agencies receive 100-, 90-, or 80-percent reinsurance depending on their default rate. If they receive less than 100 percent, the percentage lost is deducted from a defaulter's payment before computing the Secretary's equitable share.

because the guaranty agency would first deduct its 30 percent from the amount due the Department ($1,000,000 less 30 percent). In the second example, assume that in addition to the above analysis, the guaranty agency added reasonable collection costs (25 percent) to the borrowers' debts, resulting in a total repayment of $1,250,000. Under existing requirements the guaranty agencies can keep the $250,000 in collection costs, plus retain another $300,000 (30 percent x $1,000,000), and the Department receives the remaining $700,000. However, if the Department shared in all default payments, it would receive $875,000 [70 percent x ($1,000,000 + $250,000 collection costs)]. The net loss to the federal government on the default would then only be $125,000, compared to $300,000 in the previous example.

Follow Federal Standards in Recording Payments

The Department's revised regulations require that default payments be applied first to accrued interest, then to principal, and then to other costs and charges. In contrast, the Federal Claims Collection Standards (Joint Standards) specify that payments be recorded (i.e., posted) to all other costs and charges first and to principal last. In addition, the Joint Standards require that when borrowers fail to abide by their repayment agreements, all unpaid costs can be capitalized (added to principal) in any new agreement, thus increasing the borrowers' balances on which interest will accrue.

Departmental Process for Posting Payments

The Department's previous regulations allowed guaranty agencies to apply borrower payments to either the outstanding principal or accrued interest of the loan. We found from our questionnaire results that 29 percent of all agencies were first posting default payments to the loan principal—resulting in less interest charged to borrowers and increased costs for the federal government. Department officials say they now require agencies to post payments to accrued interest first, because borrowers who default and have their payments applied to principal first would pay less over the life of the loan than would borrowers who do not default. The Department also stated that this would be unfair to borrowers who honor their repayment obligations.

Federal Standards for Posting Payments

Federal agencies performing a collections function, such as the Department of Education, are required to follow the Joint Standards, as previously discussed, unless other laws or regulations apply to their collection activities (see p. 30). Section 102.13 of these standards covers

interest, penalties, and administrative costs. Section 102.13(f) states that

"When a debt is paid in partial or installment payments, amounts received by the agency shall be applied first to outstanding penalty and administrative cost charges, second to accrued interest, and third to outstanding principal."

As a result, the government obtains more monies under this method than the Department may receive from guaranty agencies.

Capitalize All Unpaid Costs

Section 102.13(c) of the Joint Standards states that agencies should not capitalize or accrue interest on interest, penalties, or administrative costs. If a debtor defaults on a payment agreement, however, then charges that accrued, but were not collected under this defaulted agreement, shall be added to the principal (i.e., capitalized) of any new agreement. In comparison, the Department has no requirement that guaranty agencies capitalize interest on all unpaid costs for borrowers who do not meet their repayment terms, because Department officials said that guaranty agencies already have the authority to capitalize interest. However, to ensure that all agencies are capitalizing these unpaid costs, the Department should incorporate this provision in its regulations.

Continue the Tax Refund Offset Program

The Deficit Reduction Act of 1984 (Public Law 98-369) authorized the Secretary of the Treasury to collect delinquent debts owed the government by offsetting them against tax refunds payable after December 31, 1985, and before January 1, 1988. This 2-year period was established to determine whether the tax refund offset program (1) increased the amount of nontax debts collected and (2) changed taxpayers' filing and withholding practices.

During the first year, the program involved certain delinquent debts owed to five federal agencies—the Departments of Agriculture, Education, and Housing and Urban Development; the Small Business Administration; and the Veterans Administration. These agencies were selected for participation by the Office of Management and Budget and IRS.

According to Department records, as of December 31, 1986, the Department of Education offset over 246,000 individuals' tax refunds and collected $132 million from those who had defaulted on Perkins Loans, Federally Insured Student Loans, and Guaranteed Student Loans. The

results for the Guaranteed Student Loan Program showed 67,000 individuals offset, with recoveries of $38 million.

On February 9, 1987, we reported to the former Chairman, Subcommittee on Energy, Nuclear Proliferation, and Government Processes, Senate Committee on Governmental Affairs, (see GAO/GGD-87-39BR), that

- the offset program was quite successful,
- very few individuals were wrongly offset, and
- the cost of administering the program was small in comparison to the results obtained.

As of September 4, 1987, the Department had received another $137 million, from the second year's effort, with $79 million of that amount coming from defaulters having guaranteed student loans. The future success of the program for agencies like the Department of Education, however, depends on whether the program is reauthorized by the Congress.

In March 1987, S. 685 was introduced to permanently extend the program only for loans authorized by the Higher Education Act. In comparison, in a March 11, 1987, letter from the IRS Commissioner to the Assistant Secretary for Tax Policy, Department of the Treasury, the IRS Commissioner supported a 2-year extension of the entire program. He believed that before the program is permanently extended, additional time is needed to adequately measure the impact on tax administration on those individuals who may have been offset. This 2-year extension is also supported in H.R. 2367, which was introduced in May 1987.

Conclusions

Many legislative and regulatory changes occurred in 1986 that affected the Guaranteed Student Loan Program. These changes, if properly implemented, should improve the operation of the program, reduce defaults, and increase collections. We believe that additional changes are needed, however. If implemented, these changes could further reduce program default costs and increase federal revenues by those who would repay their debts.

Most of these additional changes would increase the debt burden to those borrowers who default. Such an increase could act as a deterrent to help prevent borrowers from defaulting, as will most of the changes we are recommending. The Department's efforts to reduce program fraud and abuse could also be improved by establishing the National

Student Loan Data System and using the system as a verification tool. Millions of dollars could potentially be saved annually in erroneously awarded student assistance.

The Congress should continue the IRS tax refund offset program for defaulted student loans, considering its low cost and high yield. In addition, one factor that cannot fully be measured is the deterrent effect the program may have had on taxpayers who contemplated defaulting on a student loan but did not because of this program.

Recommendations

We recommend that the Congress amend the Higher Education Act by

- requiring that a borrower's promissory note specify that, upon default, the loan interest rate will change to a variable rate with a ceiling of 12 percent, unless existing state law allows for a higher rate to be charged; and
- providing the Department of Education with the authority to require that guaranty agencies use the National Student Loan Data System to verify borrower eligibility after the system is established.

In addition, we recommend that the Congress continue the income tax refund offset program for tax years 1987 and 1988 for defaulted student loans.

We also recommend that the Secretary of Education amend the Guaranteed Student Loan Program regulations by requiring that guaranty agencies

- share all borrower payments made to offset collection costs on reinsured loans with the Department of Education,
- post borrower payments in the same manner that federal agencies are required to do in accordance with the Federal Claims Collections Standards, and
- capitalize interest on defaulters' unpaid costs when they fail to follow their repayment agreements.

Agency Comments and Our Evaluation

Department of Education

In a letter dated September 11, 1987, the Assistant Secretary for Postsecondary Education stated that the Department generally concurred with our recommendations. He said the Department strongly supported our recommendations to the Congress on removing the restriction on the National Student Loan Data System and extending the income tax refund offset program.

However, the Assistant Secretary suggested some modifications to our recommendation that the Congress should increase a borrower's interest rate upon default. He recommended that the base interest rate at default be the higher of the original rate specified in the promissory note or the Treasury bill rate for the preceding 12 months (market rate). This base rate would remain fixed for the life of the loan. He also recommended that the Secretary be given the authority to assess a penalty rate, which could be up to 6 percent above the base rate. The Assistant Secretary stated that this 6 percent penalty rate is allowed by the Debt Collection Act. He also suggested that we expand our recommendation to include loans owed and guaranteed by other federal government programs.

We agree with the Department that the new loan interest rates should (1) be equal to the market rate and (2) not be reduced below the original rate specified in the promissory note. However, we disagree with the Department that the rate should remain fixed. Rather, we believe that it should be adjusted annually, consistent with the PLUS and SLS programs (see p. 38). Also, we are not recommending that a penalty rate be assessed at this time, because we believe the use of a market rate generally will increase interest rates on defaulted loans by 3 to 5 percent. We are not recommending that the Congress make such changes to all loans owed or guaranteed by the federal government because our review covered only the Guaranteed Student Loan Program.

While agreeing with our recommendation that the Department share in all payments made by defaulters, the Assistant Secretary believed the Department needs to study the concept before proposing the best approach for implementation. He said that the Department would work with GAO to develop a workable sharing methodology before amending its regulations. According to the Assistant Secretary, defaulters should

bear the cost that guaranty agencies incur when collecting defaulted loans and that current law already is generous in defraying the guaranty agencies' costs with the administrative cost allowance (see p. 12) and full reinsurance provisions. He believes the Department should also benefit when defaulters reimburse the agencies for their costs.

Internal Revenue Service

In a letter dated September 14, 1987, the Commissioner of the IRS recommended that the income tax refund offset program be extended for only a 2-year period because the IRS is concerned that the program could have a negative effect on taxpayer compliance. In a draft of this report we suggested that the program be continued without specifying a particular time period. According to the Commissioner, the results of earlier studies done on the child and spousal refund offset program found that taxpayers who were offset were more likely not to file a return in succeeding years or were delinquent in filing their returns. The Commissioner also cited another study underway that is covering the 1985 tax refund offsets—including offsets for defaulted student loans—and the effect of these offsets on tax year 1986 returns filed by those taxpayers. He stated that there is insufficient data at this time to evaluate the effect on taxpayer compliance. As a result, the Commissioner said IRS needs more time to collect data so that the possible impact can be evaluated.

Because we agree with IRS that additional information is needed to determine whether the program is negatively affecting taxpayer compliance, we recommend that the program be extended for a 2-year period.

National Council of Higher Education Loan Programs, Inc.

Increasing a Borrower's Interest Rate Upon Default

In comments dated September 18, 1987, the Board of Directors of the National Council of Higher Education Loan Programs, Inc., stated it had no objection to increasing a borrower's interest rate upon default. The board believed, however, that a fixed interest rate, rather than a variable rate, would be easier to administer—both for the guaranty agencies and their private collection contractors.

Our recommendation was based on the fact that agencies currently guarantee loans under the PLUS and SLS programs for which interest rates are set at market rate once a year. Because guaranty agencies must adjust these interest rates accordingly on loans when they default, we see no inherent problems in adjusting the rates for all defaulted loans.

Requiring That Guaranty Agencies Use the National Student Loan Data System

The board opposes using the National Student Loan Data System unless such use would (1) be cost-effective and (2) cause no delay in the student loan origination process. The board also stated that until the Department develops and implements the system, guaranty agencies are unable to evaluate its costliness, its potential for delaying the origination process, and its usefulness in preventing fraud and abuse.

We believe that the OIG study mentioned on page 40 has demonstrated the potential cost-effectiveness of this system. And because the design of this system has just begun, guaranty agencies could work with the Department of Education in developing a system that overcomes their concerns.

Continuing the Tax Refund Offset Program

The board strongly supported a permanent extension of the income tax refund offset program. They suggested, however, that the system used in offsetting defaulters be modified, so that litigation—a valuable collection tool—be allowed before, during, and after the offset process. While we agree with the board that litigation is a valuable collection tool, its use relative to the offset process was not within the scope of our review.

Sharing All Default Payments

The board believed the guaranty agencies' collection efforts are enhanced because they can retain all payments made to offset collection costs. The board stated that collection costs are a major expense incurred by the agencies, rather than the Department, and, therefore, the department should receive no portion of defaulter payments made to offset such costs.

We agree that attempting to collect from defaulters can be an expensive process and that retaining payments made to offset collection costs serves as an incentive for agencies' collection efforts. However, we believe, as cited previously by the Assistant Secretary for Postsecondary Education, that current law already is generous in defraying this cost to the agencies, including the full reimbursement provisions for

default claims as well as an administrative cost allowance and the retention of 30 percent of all default payments. This 30 percent was intended by law to cover these agencies' costs for participating in the program, including the administrative costs of collection, such as attorneys' fees and fees paid to collection agencies. As a result, we believe that the agencies have sufficient means to offset their collection expenses and should provide the Department with a share of all default payments made on reinsured loans.

Posting of Payments to Principal Last

The board believed that our recommendation requiring the posting of default payments to all penalty and administrative costs first, then to accrued interest, and to principal last would result in significant one-time data processing costs for the agencies. The board also believed that such a method would be a disincentive for defaulters to repay their loans, because defaulters would see no immediate reduction in their liability for defaulted principal and interest. However, the board did recognize the Department's preliminary results on defaulted loans it collects. These results showed that the threat of added collection costs and application of payments to such costs prior to interest and principal, has resulted in repayment by some defaulters. Nonetheless, the board supports relaxation of the Department's current regulations (rather than strengthening) to allow the guaranty agencies flexibility in dealing with defaulters.

It is likely that agencies will incur additional data processing costs in changing their methods of applying default payments. However, our recommended method would also raise additional revenue for both the agencies and the federal government while providing additional incentives for prompt payment by defaulters. We view this recommendation and others as encouragement for defaulters to become current because collectors can explain to defaulters that every delay in repaying will result in higher debt and increased costs. In addition, as cited by the board, the threat of added collection costs and applying payments to such costs has made some defaulters begin to repay, rather than ignore repayment.

Capitalizing All Unpaid Costs

The board agreed in principle with our recommendation but believed it would be administratively difficult for guaranty agencies and their collection contractors to implement. The board stated that although this recommendation would maximize the charges to a defaulter, it, along

with other of our recommendations, may serve as a disincentive for defaulters to repay their debts.

We agree that implementing this recommendation would require some administrative changes. As noted earlier, we also believe that this recommendation and others should provide an added incentive for borrowers to remain current and defaulters to begin and continue repayment.

Examples of Major Changes to the Guaranteed Student Loan Program Made by the Consolidated Omnibus Budget Reconciliation Act of 1985

Program provision before change	Change	Effect of change
Funds borrowed by the student are disbursed by check payable to the order and requiring the endorsement of the student	Requires that loan proceeds be distributed to the school by check or other means payable to and requiring the endorsement or other certification by the student	Ensures that the student borrower actually attends the school for which the loan was made
None	Requires lenders to make multiple disbursements of loans for any period of enrollment of more than 6 months, one semester, two quarters, or 600 clock hours and for an amount of $1,000 or more	Ensures that the borrower does not receive all loan money at the beginning of the school year
None Note: Default means nonreceipt of payment for 120 days for loans payable in monthly installments and 180 days for loans payable in less frequent installments	Requires that guaranty agencies may not file claims for reinsurance prior to 270 days of delinquency. Also, amends the definition of default to mean nonreceipt of payment for 180 days for loans payable in monthly installments and 240 days for loans payable in less frequent installments.	Allows the lender an additional 60 days to get the borrower into repayment
None	Each state is to establish a lender of last resort to make loans to students otherwise unable to obtain them	Ensures students access to loan money
None	Allows for loan consolidation permitting a borrower to make a single payment to be applied toward his/her total indebtedness. The length of repayment may extend up to 15 years depending on the total amount owed	Provides borrowers with a simpler arrangement but could extend the time for repaying his/her loan in full
None	Requires financial and compliance audits of all guaranty agencies at least every 2 years	Will provide the Secretary of Education accountability of the operation of guaranty agencies
None	Requires defaulters to pay reasonable collection costs incurred by the guaranty agencies in the collection of defaulted loans	Increases revenue from those who default and repay and could deter borrowers from defaulting

(continued)

Program provision before change	Change	Effect of change
None	Requires the Secretary of Education, guaranty agencies, lenders, and subsequent holders of loans to contract with credit bureaus to exchange information. In addition, all loans must be reported to credit bureaus	To enhance collection efforts of guaranty agencies, lenders, and subsequent loan holders
None	Permits the Secretary to impose civil penalties of up to $15,000 on lenders and guaranty agencies that violate or fail to carry out statutory or regulatory requirements or substantially misrepresent the nature of financial charges	Gives the Department a tool to ensure program is properly administered
None	Establishes a minimum federal statute of limitations of 6 years following the date a guaranty agency pays a default claim or 6 years from the date a guaranty agency loan is assigned to the Secretary of Education	Ensures that collection activities continue for a minimum period of 6 years

Examples of Major Changes to the Guaranteed Student Loan Program Made by the Higher Education Amendments of 1986

Program provision before change	Change	Effect of Change
None	Students must be enrolled in a degree or certificate program to be eligible for a GSL	Ensures that students who are not enrolled in a program granting a degree or certificate do not receive a GSL
Cumulative borrowing limits under GSL of $12,500 for undergraduate students and $25,000 for combined undergraduate and graduate or professional education programs	Cumulative borrowing limits set at $17,250 for undergraduate programs and $54,750 for combined undergraduate and graduate or professional programs	Raises amounts available to borrowers
Borrowers are charged up to 9 percent interest on their loans (current rate is 8 percent)	Starting July 1, 1988, new borrowers will be charged 8 percent on their loans for the first 4 years of repayment and 10 percent for the balance of the repayment period	Increases interest rate from 8 to 10 percent in the fifth year of repayment
Students from families with income over $30,000 must demonstrate financial need to qualify for a subsidized GSL	All borrowers must undergo a financial needs test to qualify for a subsidized GSL	Eliminates automatic eligibility for subsidized GSLs for students of families whose income is under $30,000
Loans are to be disbursed by the lender in two or more installments with the interval between the first and second installment no less than one-third of such period	Multiple disbursement provision amended to allow the second disbursement to be made after the first third of the academic year is passed	Further clarifies the multiple disbursement provision
Authorized guaranty agency or its contractor to provide supplemental preclaims assistance for default prevention	Requires that if a contractor is used, the contractor cannot provide supplemental preclaims and collection assistance upon default on the same loan	Prevents conflict of interest by the contractor
None	Lenders must submit proof that reasonable attempts were made to locate and contact a defaulted borrower	Lenders must be able to document their efforts to locate defaulted borrowers
None	To the extent provided for in regulations, guaranty agencies can permit forbearance (temporary reduction or stoppage of loan payments) on defaulted loans	Encourages defaulters to repay by authorizing temporary reductions or suspensions of payment
None	Guaranty agencies may provide information to institutions on former students in default	Allows institutions to determine what actions, if any, they may take against former students now in default

(continued)

Program provision before change	Change	Effect of Change
None	Provides a 3-year pilot program to test the feasibility of rehabilitating defaulted loans for borrowers unemployed or institutionalized at the time of default	Gives a borrower a chance to rectify their defaulted loan
The Secretary of Education may impose civil penalties of up to $15,000 for program violators	Penalty raised to $25,000	Provides stiffer penalty for violating the statutory or regulatory provisions of the program
None	The Secretary of Education may sell loans that are not in repayment	Enables the Secretary to recover part of the debt owed by defaulted borrowers
None	The lender must provide the borrower with a statement of the total amount of GSL indebtedness and an estimate of monthly payments due	Informing borrowers of their projected indebtedness may enhance repayment
None	Institutions must conduct exit interviews with borrowers informing them of their average indebtedness and anticipated monthly payments	Interviews should enhance repayment
None	Authorizes the Department to establish a National Student Loan Data System containing information regarding loans made, insured, or guaranteed under the GSL or Perkins Loan programs	The data system can be used for research, improvement of federal debt collection practices, and as a data base for information requested by congressional committees
Guaranty agencies may retain up to 30 percent of borrower payments to cover various administrative costs to the extent they have incurred those costs and do not exceed 30 percent	Guaranty agencies may retain 30 percent of collections to cover agency costs without proof of such incurred costs to the agency	Guaranty agencies no longer have to compute their administrative costs but can claim a flat 30 percent of payments received as their collection costs
Guaranty agencies may retain 30 percent of default collections regardless of state garnishment law	Guaranty agencies in states that have enacted a qualified garnishment statute may retain 35 percent of collections	Encourages states to adopt additional means for collection to retain an extra 5 percent of collections
None	The Secretary of Education is directed to conduct a series of studies to include: (1) the escalating cost of higher education, (2) a survey of student aid recipients, and (3) the treatment of students under Chapter 13 bankruptcy proceedings	By conducting these studies the Secretary (and the Congress) should have an idea of the effectiveness of selected aspects of the GSL program

(continued)

Program provision before change	Change	Effect of Change
None	GAO must conduct several studies to evaluate (1) the practices of state and multistate guarantors, (2) the use of multiyear lines of credit, (3) the impact of multiple disbursements, and (4) the cost and efficiency of the loan consolidation program	These studies should provide some insight as to the possible impact of several of the programs established by the amendments, as well as highlighting program aspects that could be improved

Comments From the Department of Education

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF THE ASSISTANT SECRETARY FOR POSTSECONDARY EDUCATION

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Human Resources Division
Washington, D.C. 20548

SEP 11 1987

Dear Mr. Fogel:

Thank you for the opportunity to comment on the draft audit report dated August 18, 1987, entitled "Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs."

The Department generally concurs with the recommendations and the intent of the GAO report. Our major concerns and comments are discussed below:

Now on p. 45.

Page 67: We agree in principle with GAO's recommendation to change the interest rate for defaulted loans. We recommend that the floor interest rate always be the amount on the note. That is, a debtor could never pay less than the amount originally signed for. The base rate, established at the time ED acquired the loan, would be the Treasury bill rate for the preceding twelve months. It would not float, but would stay the same for each loan for the life of the loan. The ceiling rate would be the up-to-six-percent penalty interest allowed by the Debt Collection Act. Both the base rate and the ceiling rate would be charged at the discretion of the Secretary.

This system would ensure that debtors will always pay at least the amount on the promissory note, but may pay as much as six percent above Treasury bill rates.

Also, we believe that GAO should recommend this both for loans owed to AND GUARANTEED BY the Federal Government. This would require the Guarantee Agencies to adopt identical measures.

The Department strongly supports legislative action to remove restrictions on the use of the National Student Loan Data System. We proposed legislation earlier this year as part of the Administration's suggested technical amendments package and would welcome timely action on this issue.

Now on p. 45.

Page 67: The Administration has urged the Congress to extend the IRS offset authorization beyond the 1986 tax year. With the strong support of the Department, the U.S. Treasury submitted language supporting the extension to the appropriate committees of the House and the Senate in April of 1987. Recently assurances have been received by the Department from the House Ways and Means Committee and the Senate Appropriations Committee that the Congress intends to extend the offset authorization. However, to date the Congress has yet to act while the Department prepares, based upon the Congress' assurances, to implement the IRS offset for tax year 1987.

400 MARYLAND AVE. S.W. WASHINGTON, D.C. 20202

Now on p. 37.

Page 67: The Department agrees with the recommendation of reducing the time from 60 to 30 days for the Guarantee Agencies to return collections to the Department and will take the regulatory steps to implement this recommendation.

In addition, as permitted by recent legislation, the Department has notified those defaulters whose notes it holds that, effective October 1, 1987, collection costs ranging from 25 to 45 percent of the outstanding principal will be added to the defaulters' accounts.

Now on p. 45.

Page 67: Again, we agree with GAO that the Secretary should receive an equitable share of all payments made to Guarantee Agencies by defaulted borrowers for collection costs.

The Department believes: (1) that defaulted borrowers must bear the cost that agencies incur when collecting their defaulted loans; and (2) that current law already is generous in defraying administrative costs incurred by Guarantee Agencies through the Administrative Cost Allowance (ACA) and through the 100% reinsurance provision. Therefore, as borrowers reimburse agencies for expenses incurred, the Department should benefit too. Otherwise it might give the appearance that Guarantee Agencies are receiving duplicate payments for collection costs.

We have not determined whether a straight 70/30 split is the ideal solution or the best manner to implement the recommendation. The Department will need time to consider this specific recommendation as well as time to consider other alternatives. We will work with GAO to reach an agreeable approach for resolving this issue.

Sincerely,

C. Ronald Kimberling
Assistant Secretary for
Postsecondary Education

Comments From the Internal Revenue Service

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER

SEP 14 1987

Mr. William J. Anderson
Assistant Comptroller General
General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

We appreciate the opportunity to review your recent draft report entitled "Guaranteed Student Loans: Legislative and Regulatory Changes Needed to Reduce Default Costs".

The report correctly notes that IRS has supported a two year extension of the offset program in order to give us an opportunity to complete a study on the effect of refund offsets on voluntary compliance. However the report's recommendation to Congress, that the refund offset program be continued, does not include the Service's previously stated cautions.

Based on the results of earlier studies of the child and spousal support refund offset program, we found that taxpayers who were offset were more likely not to file a return in succeeding years and that the percentage of tax payment delinquency cases was greater for taxpayers who had their refunds offset for child support debts. To see if these results hold true for other types of non-tax offset programs, including offsets for defaulted student loans, we initiated a new study covering the tax year 1985 refund offsets and the effect of these offsets on tax year 1986 returns filed by these taxpayers. The study will attempt to measure the impact of the previous year's offset on subsequently filed returns. While we are concerned about a possible negative impact on taxpayer compliance, there is insufficient data at this time to demonstrate the effect on compliance. We need more time to evaluate the possible impact. Until we complete an analysis of data from the current program and from follow-up years, we recommend only a two-year extension of the offset program.

We hope these comments are useful in preparing your final report.

With best regards,

Sincerely,

Larry Dixon

Comments From the National Council of Higher Education Loan Programs, Inc.

NCHELP

National Council of Higher Education Loan Programs, Inc.

Suite # 300, 804 " E " Street, S.E.

Washington, DC 20003 • (202) 547-1571

September 18, 1987

On September 14, 1987, the Board of Directors of the National Council of Higher Education Loan Programs, Inc., adopted the following response to the recommendations contained in the Draft Report by the General Accounting Office--"GUARANTEED STUDENT LOANS: Legislative and Regulatory Changes Needed to Reduce Default Costs." (The GAO's recommendations are set forth in bold face; the Council's responses are set forth in italics.)

GAO makes several recommendations to the Congress and the Secretary of Education which would reduce the federal government's costs. The Congress should:

- **convert defaulting borrowers loan interest rates to a variable market rate consistent with the rates charged borrowers who default on non-subsidized loans.**

NCHELP does not object to the concept of charging defaulting borrowers a higher rate of interest; it has proposed such a legislative change in the past. However, the Council would prefer that the interest rate be a fixed rate. While lenders are currently administering variable rate instruments as part of the SLS and PLUS Programs, a variable rate note would be very difficult for guaranty agencies and collection agencies to administer.

- **Provide the Department with the authority to require that guaranty agencies use the National Student Loan Data System after it is established to reduce fraud and abuse.**

NCHELP opposes required use of the National Student Loan Data System unless the System can be designed to be cost-effective and its use streamlined so as not to slow the origination process.

It is still unclear that the system as currently specified appropriately fills the need intended. Until the Department of Education develops and implements the System, guaranty agencies are unable to evaluate its costliness, potential for delaying the origination process (to the detriment of student borrowers), and its usefulness in preventing fraud and abuse.

- **Continue the income tax refund offset program for student loans.**

NCHELP strongly supports the permanent extension of authority to offset GSL defaults against income tax refunds. However, the system needs to be modified to allow for litigation before, during, and after the offset process, so that a valuable collection tool is not abandoned.

The Secretary should amend the program regulations to require that:

- **all payments by defaulters to offset collection costs be shared with the Department;**

NCHELP believes that an unshared 30 percent retention by guaranty agencies is an important incentive to good collections practices.

Collection costs are an expense of the guaranty agencies, and collections made to cover those costs should not be shared with the Department of Education, which did not incur them.

- **repayment periods for defaulted loans generally be limited to 3 years;**

NCHELP agrees in principal that full and fast repayment should be sought from all defaulted borrowers. However, it cannot support a requirement that the repayment period should be shortened to three years, by regulation. In the case of defaulters with high outstanding balances, such a limited repayment period could serve as a disincentive to entering into a repayment agreement. The regulations should encourage repayment in as short a time-period as is feasible, but not mandate any specific reduced repayment period.

- **repayments by defaulters be applied first to all penalty and administrative costs, then to interest, and lastly to principal;**

Current regulations of the Department of Education require that default payments be applied first to interest, second to principal, and only thereafter to accrued charges and penalties for collections. The recommended change would require a very significant data processing change in most existing collections systems, a not insignificant expense to guaranty agencies and collectors.

Some NCHELP Members expressed concern that application of such payments to collections costs first could serve as a disincentive to some defaulters, since they would not see any immediate reduction in their liability for defaulted principal and interest. However, preliminary data from the Department of Education concerning its experiment with imposing collections costs on outstanding balances, and applying payments first to such costs, indicates that in some cases the threat has actually spurred repayments by defaulted borrowers.

NCHELP support relaxation of the current rigid regulations to allow flexibility to guaranty agencies in the application of payments from defaulted borrowers, to maximize the return to guaranty agencies and the Federal government and to avoid the possibility that defaulters get a "better deal" than students who regularly repay their loan obligations.

- **Interest accrue on all unpaid costs when defaulters fail to adhere to their repayment agreements; and**

NCHELP agrees in principal with the GAO recommendation, but recognizes that this is administratively difficult for guaranty agencies and collection firms. While this suggestion would maximize the charge to the defaulted borrower it could, again, serve as a disincentive for a seriously defaulted borrower to agree to reenter repayment.

- **guaranty agencies remit collections to the Department within 30 days of receipt.**

The form for transmitting collections to the Department is filed on a monthly basis. It is probable that agencies will collect payments which would not be within the window for inclusion in the Form 1189 for the current month, but would be received more than 30 days from the date of submission of the Form 1189 for the next month.

NCHELP suggests that a 45-day requirement for submission of collections receipts would achieve the goal sought by GAO while recognizing the filing dates for the Form 1189.

Several of the GAO recommendations are viewed by NCHELP as posing specific difficulties in the administration of accounts between guaranty agencies and collection vendors. The significance of the data processing effort required to accommodate these changes must not be underestimated.

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Recent GAO Reports and Testimony Related to Guaranteed Student Loans

Reports

Guaranteed Student Loans:
Better Criteria Needed for Financing Guarantee Agencies
GAO/HRD-86-7, 7/2/86

Defaulted Student Loans:
Guaranty Agencies' Collection Practices and Procedures
GAO/HRD-86-114BR, 7/17/86

Guaranteed Student Loans:
Guidelines for Reducing Guaranty Agency Reserves
GAO/HRD-86-129BR, 8/7/86

Defaulted Student Loans:
Private Lender Collection Efforts Often Inadequate
GAO/HRD-87-48, 8/20/87

Testimony

The Department of Education's Actions to Collect Defaulted Student Loans, statement of William J. Gainer, Associate Director, Human Resources Division, General Accounting Office, before the Subcommittee on Postsecondary Education, House Committee on Education and Labor, 6/19/85

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